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CIGARETTE SMUGGLING

Information on Interstate and U.S.-Canadian Activity

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Food and Agriculture Issues,
Resources, Community, and Economic
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Mr. Chairman and Members of the Task Force:

Thank you for the opportunity to discuss the results of our work on cigarette smuggling. As you know, this is part of a larger body of work we are conducting on issues surrounding the proposed tobacco settlement.[1] In conducting this work, we are addressing a wide variety of issues, including the national and regional economic impacts of the tobacco industry, smoking trends among youths in the United States and Canada, and the effect of a settlement on state excise taxes. As you requested, our statement today focuses on information concerning cigarette smuggling—in particular, interstate cigarette smuggling in the United States and Canada's recent experience with international smuggling. In summary, we found the following:

- Smuggling cigarettes from low- to high-tax states, or interstate smuggling, prominent in the 1970s, may now be a reemerging problem. Such activity is likely to occur when the differences in cigarette taxes across the states are significant enough to make it profitable. Recently, many states have opted to sharply increase their cigarette taxes. Yet most low-tax states have not. As a result, recent studies suggest that the level of interstate smuggling activity may now be increasing. In fact, recent estimates suggest that smuggling is responsible for states collectively losing hundreds of millions of dollars in annual tax revenues.
- In addition, recent experiences demonstrate that international smuggling can occur when cigarette tax differentials are substantial. International smuggling has occurred recently between Canada and the United States. According to the Canadian government, sharp increases in Canadian federal and provincial cigarette taxes in the late 1980s and early 1990s led to large-scale smuggling between the United States and Canada conducted almost entirely by organized crime. Violence increased, merchants suffered, and in one year alone, Canada and its provinces lost over $2 billion (in Canadian dollars) in tax revenues. Canada responded in 1994 by sharply reducing federal and provincial cigarette taxes and increasing its enforcement efforts, among other steps. Since then, smuggling has declined considerably.

To address these issues, we discussed U.S. interstate cigarette smuggling and U.S.-Canadian international smuggling with the Bureau of Alcohol, Tobacco, and Firearms (ATF) officials; reviewed estimates of interstate cigarette smuggling prepared by the Washington State Department of

[1]This body of work will be presented in Tobacco: Issues Surrounding a National Tobacco Settlement (GAO/RCED-98-110), scheduled to be released in mid-May 1998.

Health; and tested the Washington State estimates using an alternative methodology. To understand Canada's experience with international smuggling, we reviewed the Canadian Government Action Plan on Smuggling, a study conducted for the National Coalition Against Crime and Tobacco Contraband,[2] and a report by the Canadian Office of the Auditor General. Again, we would like to stress that the information that follows will be included in a more expansive report scheduled to be released in mid-May 1998.

Interstate Smuggling: a Reemerging Problem as Differences in States' Taxes Increase

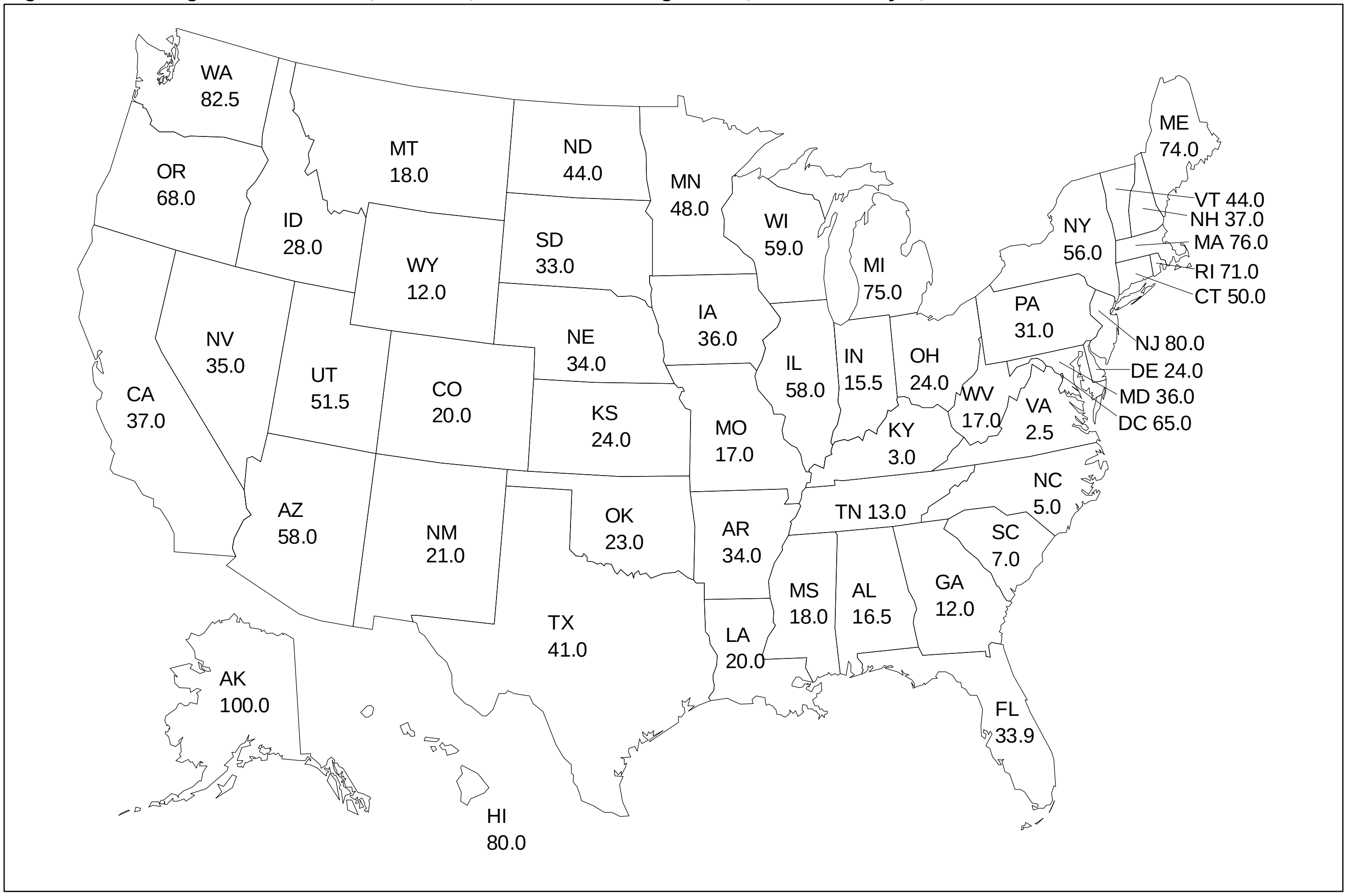
According to ATF, cigarettes are currently being smuggled across state borders to avoid the payment of state excise taxes, and such smuggling can violate federal and/or state laws.[3] The opportunity for individuals to profit from interstate smuggling exists because of the wide disparity in excise taxes across the states. As of January 1, 1998, state excise taxes on cigarettes ranged from 2.5 cents per pack to $1.00 per pack (see fig. 1). According to estimates from the Washington State Department of Health on the extent of current smuggling activity, some states are losing nearly $100 million annually in potential tax revenues.[4]

[2]The National Coalition Against Crime and Tobacco Contraband is a U.S. coalition composed primarily of retailers, wholesalers, and tobacco manufacturers. The coalition's report on smuggling entitled Cigarette Smuggling in the United States (Aug. 15, 1994) was prepared by Lindquist Avey Macdonald Baskerville, Inc.

[3]It is unlawful for any person to ship, transport, receive, sell, distribute, or purchase 60,000 cigarettes or more that bear no evidence of state tax payment in the state in which the cigarettes are found, if such state requires a stamp to demonstrate payment of taxes (18 U.S.C. 2342). States may also have stricter laws related to cigarette smuggling. For example, in Maryland, it is generally illegal for a consumer to bring into the state more than two packs of cigarettes on which Maryland taxes have not been paid.

[4]These estimates treat all forms of tax avoidance—both large and small—as "smuggling," even though some actions, such as local cross-border purchases in small quantities, may not be illegal.

Figure 1: State Cigarette Tax Rates, in Cents, Per Pack of 20 Cigarettes, as of January 1, 1998



Source: The Tobacco Institute.

The incentives to smuggle cigarettes into any particular state obviously depend on the amount that the state's tax rate exceeds that of neighboring or other states. Substantial differences in states' tax rates in the late 1960s and early 1970s encouraged significant smuggling activity. By the early 1980s, the nominal value of tax rate differentials had stabilized, but because of inflation, the constant dollar value of the differentials—and thus the profitability from smuggling—had eroded. For example, a 25-cent difference in tax rates in 1997 dollars is worth less than a 25-cent difference in tax rates in 1980 dollars. In addition, law enforcement efforts may have added to the risk of smuggling. As a result, smuggling declined. Since the mid-1980s, however, tax rates have increased substantially in some states. By 1996, differences in states' tax rates had returned to mid-1970s levels in constant dollars—thereby restoring incentives for smuggling. Consequently, according to recent studies, the profitability, and therefore the extent, of interstate smuggling activity is likely to have increased in recent years.

In 1997, the state of Washington estimated the extent of interstate smuggling activity in terms of tax per day by state—which we converted to the associated loss (or gain) in state tax revenue. Washington State's estimates were derived using an approach that statistically determines how demographic factors, such as income and religious preferences, and differences in tax rates relative to other states affect cigarette sales on which state taxes are paid. The estimated relationships can then be used to simulate actual consumption.[5] The amount by which estimates of actual consumption exceed estimates of taxed sales in a state would then represent the net cigarettes smuggled into that state. Using survey data provided by the Centers for Disease Control and Prevention, we tested the Washington State estimates and found them to be reasonable.

On a national level, the Washington State study indicated substantial smuggling from states with low tax rates to states with high tax rates. For example, the estimates of tax revenue losses in the states with the highest tax rates at the time the Washington State study was done—Washington and Massachusetts—were $52 million and $61 million annually, respectively.[6] Similarly, the estimates of tax revenues lost for New York, a state with a slightly lower tax rate but which has a large population, exceeded $90 million annually. Exporting states, such as Kentucky, North Carolina, and Virginia, showed only modest revenue gains because their tax rates are so low that extra sales to buyers in the high-tax states do not generate significant tax revenue.[7]

[5]This approach was pioneered by the Advisory Commission on Intergovernmental Relations in Cigarette Tax Evasion: A Second Look, ACIR, Washington, D.C., March 1985, and recently updated in A Tax Study: Cigarette Consumption in Washington State, Washington State Department of Health, January 1997.

[6]At the time of the Washington State study, Washington, with a cigarette tax rate of 82.5 cents per pack, and Massachusetts, with a rate of 76 cents per pack, had the two highest tax rates in the United States. Since then, however, Alaska has raised its tax rate to $1.00 per pack, and Hawaii has raised its rate to 80 cents per pack.

[7]The state cigarette tax rates for New York, Kentucky, North Carolina, and Virginia have all remained unchanged since the Washington State study was done.

The results of the Washington State study and other similar studies should be viewed as providing ball-park estimates. The estimates may be imprecise for a number of reasons. Estimates of revenues lost may be (1) overstated because they do not account for the fact that smokers would buy fewer cigarettes if they were unable to avoid the state cigarette tax (and therefore pay more for their cigarettes on average) or (2) understated because they do not account for federal and state tax revenues avoided because of international smuggling.[8]

Large Increases in Canadian Cigarette Taxes Led to Widespread Smuggling Into Canada

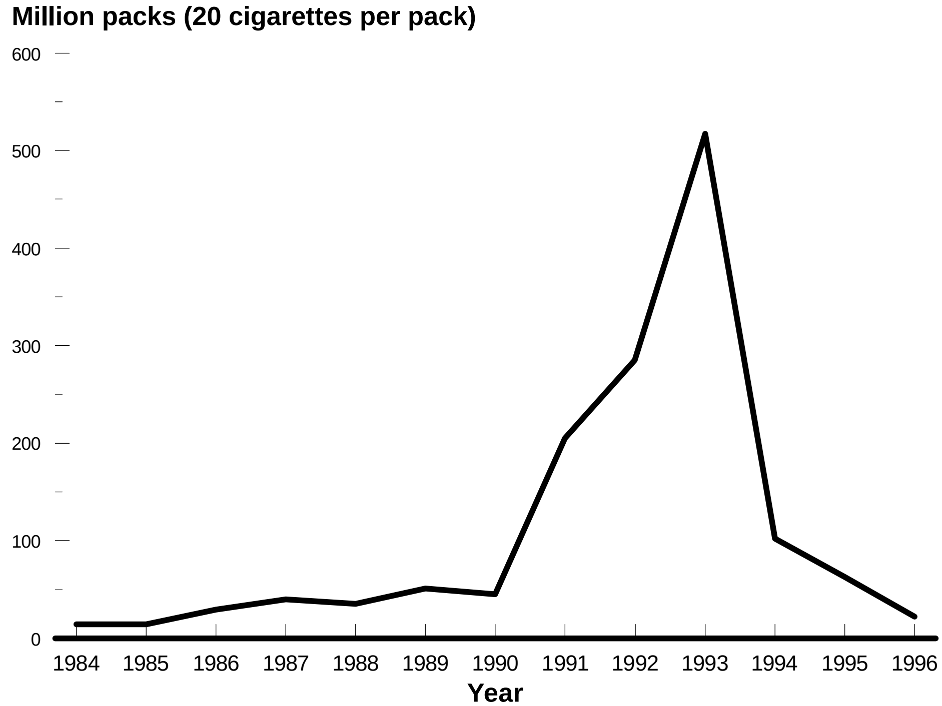
According to the Canadian government, for several years Canada increased the price of cigarettes through federal and provincial excise taxes, which resulted in a steady decline in the number of Canadians who smoke. However, these efforts had an unintended consequence—a sharp increase in smuggling activity resulting in revenue losses exceeding $2 billion (in Canadian dollars) for the federal and provincial governments in 1993 alone, according to the Canadian government. From 1984 through 1993, federal taxes on a pack of 20 cigarettes increased from 42 cents to $1.93 in Canadian dollars. Provincial taxes, levied in addition to the federal taxes, increased significantly as well. For example, from 1984 through 1993, Québec's cigarette taxes rose from 46 cents to $1.78 per pack, and Ontario's rose from 63 cents to $1.66 per pack (in Canadian dollars). As a result, the average real price of a pack of cigarettes in Canada—in 1994 Canadian dollars—increased from $2.64 in 1984 to $5.65 in 1993.

According to a 1994 study for the National Coalition Against Crime and Tobacco Contraband, because of these price increases, Canadians found lower-priced alternatives on the black market. During most of this period, cigarettes made in Canada were exported tax-free to the United States. Organized criminal groups purchased Canadian cigarettes that had been exported to the United States and smuggled them back into Canada. This resulted in more than an 11-fold increase in U.S. cigarette imports from Canada from 1990 to 1993 (see fig. 2). The 1994 study found that an Indian reserve that straddles the U.S.-Canadian border between Cornwall, Ontario, and Massena, New York, had become the primary conduit for smuggling cigarettes into Canada. Once in Canada, the cigarettes were passed through elaborate networks for distribution to vendors throughout the country. By evading the Canadian federal and provincial taxes, smugglers were able to earn huge profits from contraband cigarettes. According to the Canadian government, profits for smuggled cigarettes

[8]For some states, revenue from state sales taxes, in addition to cigarette taxes, may also decline because of cross-border purchases and contraband sales.

were an estimated $500 per case,[9] or $500,000 per truckload, in Canadian dollars.[10]

Figure 2: U.S. Cigarette Imports From Canada, 1984 Through 1996



Source: GAO's analysis of U.S. Department of Agriculture's data.

In 1993, approximately 2.1 million Canadians consumed an estimated 90 million to 100 million cartons of contraband cigarettes with a legal retail value of about $4.5 billion in Canadian dollars. That year, the problem was greatest in the province of Québec, where, the Canadian government estimated, contraband cigarettes made up over 60 percent of the market. In other parts of the country, according to the government, between 15 and 40 percent of the cigarettes sold were contraband.

[9] A case of Canadian cigarettes contains 50 cartons.

[10] Prime Minister Jean Chrétien, Government Action Plan on Smuggling, House of Commons, February 8, 1994.

While citing the effectiveness of past efforts to reduce smoking by increasing cigarette taxes, Prime Minister Chrétien stated in February 1994 that the widespread availability of relatively inexpensive contraband cigarettes was negating government controls on the distribution, sale, and consumption of cigarettes. According to the Canadian Prime Minister, as the portion of the Canadian market supplied by smuggled tobacco increased, the average price paid for cigarettes dropped. Access to cheap contraband tobacco undermined the government's health policy objectives of reducing tobacco consumption, particularly among youths. He added that he believed that Canadian tobacco manufacturers were aware that tobacco exports to the United States had been reentering Canada illegally and that these manufacturers benefited directly from this illegal activity.

In February 1994, Prime Minister Chrétien addressed the smuggling problem by proposing, among other actions,

- strengthening enforcement at targeted smuggling areas, particularly along the U.S.-Canadian border;
- reducing the federal cigarette tax by $5 per carton in all provinces, effective February 9, 1994, and matching any provincial tax reduction over $5 to a maximum federal reduction of $10 (in Canadian dollars);
- imposing an export tax of $8 per carton (in Canadian dollars) to be paid by tobacco manufacturers;
- imposing a 3-year federal surtax on tobacco manufacturers' profits to fund a major public education program and other health measures;
- requiring manufacturers to clearly mark individual cigarettes to differentiate cigarettes manufactured for domestic and export use; and
- further restricting access to cigarettes by minors.

From February 9 through April 15, 1994, federal and provincial taxes were significantly lowered in the five provinces where international smuggling was particularly troublesome, including Québec and Ontario. For example, combined taxes in Québec fell by $2.10 per pack, and taxes in Ontario fell by $1.92 per pack in Canadian dollars.[11] Although taxes in these provinces have increased slightly since, once the initial tax cuts took effect, the U.S.-Canadian contraband cigarette market dried up, according to the 1994 study for the National Coalition Against Crime and Tobacco Contraband. Consistent with the study's findings, U.S. cigarette imports from Canada dropped about 96 percent from 1993 through 1996 (see fig. 2).

[11]Based on 20 cigarettes per pack.

Thank you again for the opportunity to appear before you today. We would be pleased to respond to any questions you may have.

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